(11)

No. 156

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

LONGHORN PORTLAND CEMENT COMPANY, *Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*

SAN ANTONIO PORTLAND CEMENT COMPANY, *Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI

to the United States Circuit Court of Appeals for the Fifth Circuit

AND SUPPORTING BRIEF

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To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners, Longhorn Portland Cement Co. and San Antonio Portland Cement Co., pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above-entitled cause on March 27, 1945. The judgment of the

Circuit Court reversed decisions of The Tax Court of the United States which had held that certain expenditures were allowable deductions within the meaning of Section 23 (a) (1) (A) of the INTERNAL REVENUE CODE.

Opinions Below

The opinion of The Tax Court of the United States (R. 38) was promulgated February 21, 1944, and reported in 3 T. C. 310. The opinion of the Circuit Court of Appeals (R. 104) is reported in 148 Fed. (2d) 276.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240 (a) of the JUDICIAL CODE, as amended, 43 Stat. 938 (28 U.S.C.A., Sec. 347). The judgment of the Circuit Court was entered on March 27, 1945 (R. 108).

Statutes Involved

The statute involved is Section 23 (a) (1) (A) of the INTERNAL REVENUE CODE, which reads as follows:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

Sec. 23 (a)

(a) Expenses.—

(1) Trade or Business Expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including

a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Question Presented

Where amounts are paid to the State of Texas in compromise of a disputed claim for penalties for alleged violations of State Laws, and where the facts show that the compromise was based upon a stipulation that the payment should not be construed as an admission of the alleged violations and where the true considerations for the compromise are shown, are the amounts so paid deductible as ordinary and necessary business expenses within the meaning of Section 23(a) (1) (A) of the INTERNAL REVENUE CODE? The Tax Court found as a *fact* that the amounts paid were not penalties and held them to be allowable deductions. The Circuit Court inferred that the amounts were penalties and therefore not allowable as deductions and reversed the decisions of The Tax Court.

Summary Statement

The following facts, stated in summary form, were found by The Tax Court:

The petitioners are Texas corporations engaged in the manufacture and sale of cement (R. 39). A suit was brought against the petitioners by the State of Texas, in which it was alleged the petitioners had violated the anti-trust laws of

Texas and that the petitioners were thereby subject to statutory penalties as provided by law (R. 39).

The petitioners vigorously denied any of the asserted violations and were advised by counsel that they had a good defense to the claims (R. 40). However, in 1939, under a stipulation which clearly provided that no admission of guilt or violation should be construed therefrom, the petitioners each paid to the State of Texas the sum of $50,000 to dispose of the suit (R. 41-43). The petitioners were motivated solely by business reasons (described in full in the brief hereinafter), and not by any sense of guilt (R. 40).

In their Federal income tax returns for the taxable year 1939, the petitioners each deducted the amount so paid to the State of Texas as an ordinary and necessary business expense. The Commissioner of Internal Revenue disallowed this deduction in his notice of deficiency addressed to the petitioners for the year 1939 (R. 17). The Tax Court found that the payments were ordinary and necessary business expenses within the meaning of Section 23(a)(1)(A) of the INTERNAL REVENUE CODE, thereby sustaining the contentions of the petitioners (R. 45).

Decision of the Circuit Court

The Circuit Court of Appeals reversed the decisions of The Tax Court in this respect and held that the payments were not allowable deductions on the ground that they were payments made to extinguish a cause of action to impose a penalty and must therefore be regarded as penalty payments (R. 104).

Specification of Errors to Be Urged

The Circuit Court of Appeals erred:

(1) In disregarding the rules on review established by this Court in DOBSON v. COMMISSIONER (1943), 320 U.S. 489, and in reversing The Tax Court's finding of fact that the payments made by the petitioners were not penalty payments and were allowable deductions.

(2) In drawing inferences from the facts which have no support from the facts in treating a compromise settlement of a disputed claim as the equivalent of a penalty payment.

(3) In determining that The Tax Court applied an erroneous principle of law when the principle of law determined by the Circuit Court can have no application to the facts found by The Tax Court.

Reasons for Granting the Writ

(1) The decision by the Circuit Court of Appeals conflicts with the principles announced by this Court in DOBSON v. COMMISSIONER, 320 U.S. 489, and has so far departed from the accepted and usual course of judicial proceeding on review as to call for an exercise of this Court's power of supervision. (Supreme Court Rule 38-5(b).) Compare BINGHAM v. COMMISSIONER, — U.S. —, decided June 4, 1945.

(2) The Circuit Court of Appeals has decided a question of importance to the administration of Federal law which has not been, but should be settled by this Court.

(3) The decision by the Circuit Court of Appeals is in conflict with the weight of applicable authority pertaining to the regard to be accorded compromise settlements.

The reasons stated above will be discussed in the brief.

LONGHORN PORTLAND CEMENT COMPANY,

SAN ANTONIO PORTLAND CEMENT COMPANY,

By ______________________________

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____

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No.________

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SAN ANTONIO PORTLAND CEMENT COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

The Facts

The facts have been stated in the petition in summary form. The facts were developed before The Tax Court by oral testimony and documentary evidence, and as found by The Tax Court were as follows:

The petitioners are Texas corporations and during all the time material hereto were engaged in the manufacture and

sale of cement, each having a gross sales for the year 1939 of approximately $2,000,000 (R. 39).

During the taxable year (1939), each of the petitioners paid the State of Texas $50,000 in compromise of a suit by the State in which the petitioners were defendants. The suit was docketed in the District Court of Travis County, Texas, and was captioned "STATE OF TEXAS v. SAN ANTONIO PORTLAND CEMENT COMPANY, ET AL." (R. 39).

The suit referred to was one in which the State alleged that the defendants had violated the anti-trust laws of the State of Texas in various respects set out in great detail in the petition. By this suit, the State sought to recover statutory penalties provided by Articles 7426-7447, inclusive, REVISED CIVIL STATUTES (1925), in amounts from $50 to $1500 per day from January 1, 1930, to the date of the filing of the suit, September 21, 1939 (minimum amount claimed from each petitioner $177,450, maximum $5,323,500), and a further judgment cancelling and forfeiting the charters of the defendants, establishing and foreclosing a lien given by the above cited law against the property of the defendants, and enjoining and restraining each of the defendants from carrying out alleged agreements, conspiracies, trusts and combinations and for other general and special relief (R. 39-40).

The answer of each of the petitioners to said suit consisted of a general demurrer; a general denial, and a special denial that any acts, methods or practices used in its business were used as a result of, or pursuant to, any agreement or any unlawful purpose. No evidence was ever taken in said suit (R. 40).

The officers and directors of the petitioners were advised by their respective counsel that they had a good defense, but they were induced to and did compromise said suit, and

each paid the sum of $50,000 to the State because of the following considerations:

(a) Petitioners were convinced that it would cost less to settle the suits than the expense of carrying the litigation to an end, even though entirely successful in such litigation.

(b) Business would be disrupted over a long period of time through the necessary attendance of officers at the hearings.

(c) Unfavorable publicity would result from the newspaper reports of the trial, which would have a damaging effect upon their businesses.

(d) The injunctive relief sought by the State would not prevent them from carrying on business in the usual manner so long as the petitioners did not enter into an agreement with one another or with any competitor regarding prices and practices (R. 40).

The parties to said suit thereupon entered into a stipulation of facts which contained an express denial by the petitioners of the acts as charged in the petition, and Section III of said stipulation read as follows:

> "This agreement is made by the parties hereto solely and only for the purpose of compromising and settling the matter involved in this suit by and between the State of Texas, as plaintiff, and the defendants named herein, and it is expressly understood and agreed as a condition hereof, that neither this agreement nor the judgment to be entered thereon, nor any clause or provision of said agreement or judgment, shall constitute or be construed to be an admission or estoppel as against the various defendants herein as evidencing or indicating in any degree an admission of truth or correctness of the allega-

tions in plaintiff's petitions contained in whole or in part" (R. 42).

With the stipulation of the parties before it, the Court rendered a judgment on December 15, 1939, and after specifically reciting in detail the agreement of the parties in the compromise of said suit, the judgment provided in part as follows:

"And it appearing to the Court that said agreement is proper and in keeping with the law in such cases made and provided, and that same should be approved, and that final judgment should be entered in keeping therewith, it is:

"FIRST

"THEREFORE, ORDERED, ADJUDGED AND DECREED that the agreement heretofore entered into between the parties to this cause be and the same is hereby in all things approved.

"SECOND

"IT IS FURTHER ORDERED, ADJUDGED AND DECREED that plaintiffs, the State of Texas, have and recover of and from the defendants, San Antonio Portland Cement Company and Longhorn Portland Cement Company, jointly and severally, the sum of One Hundred Thousand ($100,000.00) Dollars in full satisfaction of all claims of the State of Texas for penalties for the alleged violations of law set out in Plaintiff's Original Petition, and in full satisfaction of all expenses of the Attorney General in investigating, instituting and preparing this cause for trial; and all costs of suit are hereby adjudged against the defendants, San Antonio Portland Cement Company and Longhorn Portland Cement Company, jointly and severally, * * * " (R. 41).

The judgment rendered contained no expression or indica-

tion of a determination that the petitioners had violated the anti-trust laws of the State of Texas, or any provision thereof (R. 42).

In their Federal income and declared value excess profits tax returns for the taxable year 1939, the petitioners each deducted the $50,000 paid to the State of Texas as an ordinary and necessary business expense. In his notices of deficiencies for the taxable year 1939, the Commissioner of Internal Revenue determined that said payments were not ordinary and necessary business expenses within the purview of Section 23 (a) (1) (A) of the INTERNAL REVENUE CODE and were not allowable deductions (R. 17).

The Tax Court sustained the petitioners' contention and found that said amounts were directly connected with the business carried on by each of the petitioners, were ordinary and necessary expenses paid or incurred in the carrying on of said trade or business, and did not frustrate public policy. Accordingly, the Tax Court determined that the payments were allowable deductions (R. 38).

Argument

1.

The decision by the Circuit Court of Appeals conflicts with the principles announced by this Court in Dobson v. Commissioner, 320 U.S. 489, and has so far departed from the accepted and usual course of judicial proceeding on review as to call for an exercise of this Court's power of supervision.

Stripped of all but its essentials, the question here involved is whether the payment of $50,000 made by each of the petitioners in 1939 to the State of Texas is to be characterized

as a *penalty* payment. The determination of the *fact* as to whether such payment is or is not in the nature of a penalty will carry with it the determination of whether the payment is or is not an allowable deduction to the petitioners for Federal income tax purposes in the year 1939. On this bare question, the Tax Court, in the exercise of its own independent judgment of the facts (compare COMMISSIONER v. HEININGER (1943), 320 U.S. 467; the last paragraph of the opinion in the case of HORMEL v. HELVERING (1941), 312 U.S. 552), found that the payment was not and could not be construed to be a penalty payment or characterized as such. In contrast therewith, the Circuit Court states that it recognizes these facts as found by the Tax Court, but proceeds to arrive at its determination on a factual premise that refutes the Tax Court's finding. In other words, the Circuit Court states that an amount paid to extinguish a claim or cause of action to impose a penalty must have been a penalty payment. This reversal of a fact essential to its determination is the error by the Circuit Court here claimed by the petitioners.

It is not deemed necessary to do more than point out the rule already announced by this Court in DOBSON v. COMMISSIONER (1943), 320 U.S. 489, reemphasized in such cases as COMMISSIONER v. HEININGER, supra; COMMISSIONER v. SCOTTISH AMERICAN INVESTMENT COMPANY (1944), 323 U.S. 119, and COMMISSIONER v. COURT HOLDING COMPANY (March 12, 1945), 89 L. Ed. 661, as to the relative positions and functions of The Tax Court and the Circuit Courts of Appeals with respect to questions of fact and identification of clear-cut mistakes of law. (Compare BINGHAM, ET AL., v. COMMISSIONER, supra). This part of the brief will therefore serve its purpose and the error of the Circuit Court will be apparent if it can be successfully demonstrated that no issue but a question of fact is involved and that the decision of the Tax Court does not contain an identifiable or clearcut mistake of law.

In the first place, there is no statute condemning payments incident to a penalty suit as non-allowable expense items. The question of non-allowance has arisen out of principles of public policy. Whether, in any given situation, public policy requires non-allowance, is essentially and fundamentally a question of fact. There are no differences between the decisions of the Tax Court, the Circuit Courts and this Court as to the established rules regarding the deductibility for Federal income tax purposes of amounts expended in successful defenses of alleged violations of law* as compared to circumstances where convictions, pleas, or established violations resulted in the payment of fines, penalties and expenses.** Had the Tax Court found that the payments were penalties it would have been bound under the doctrine of stare decisis to deny deductibility. The holding that the payments were deductible is proof that the Tax Court did not consider them to be penalty payments. Once the character

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* **Kornhauser v. The United States** (1928), 276 U.S. 145;
National Outdoor Bureau v. Helvering (C.C.A. 2, 1937), ~~80~~ 89 F. (2d) 878;
Commissioner v. People's-Pittsburgh Trust Company (C.C.A. 3, 1932), 60 F. (2d) 187;
Commissioner v. Continental Screen Company (C.C.A. 6, 1932), 58 F. (2d) 625;
Hal Price Headley (1938), 37 B.T.A. 738;
Citron-Byer Company (1930), 21 B.T.A. 308;
H. E. Bullock (1929), 16 B.T.A. 451.

** **Standard Oil Company (and affiliated Subsidiaries) v. Commissioner** (C.C.A. 7, 1942), 129 F. (2d) 363, cert. denied 63 S. Ct. 261;
Helvering v. Superior Wines & Liquors, Inc. (C.C.A. 8, 1943), 134 F. (2d) 373;
Burroughs Building Material Company v. Commissioner (C.C.A. 2, 1931), 47 F. (2d) 178;
Great Northern Railway Company v. Commissioner (C.C.A. 8, 1930), 40 F. (2d) 372, cert. denied 282 U.S. 855;
Columbus Bread Company (1926), 4 B.T.A. 1126;
Bonnie Brothers, Inc. (1929), 15 B.T.A. 1231.

of the payments is determined, i.e., whether it is paid for a successful defense, for a fine or penalty established in fact, the rule for the allowance as a deduction is clear. But as stated in the Tax Court opinion:

> "The present situation falls between these two lines of authorities."

With the foregoing rules before it, The Tax Court went to great length to carefully analyze the *facts* surrounding the instant payments, including the facts (1) that on its face the judgment entered in the local court recited that a payment was being made "in full satisfaction of all claims of the State of Texas for penalties for the alleged violations of law set out in Plaintiff's Original Petition, and in full satisfaction of all expenses of the Attorney General in investigating, instituting and preparing this cause for trial," (2) that such portion of the judgment must be read in the light of the surrounding circumstances, (3) that the allowance of the payments as deductions would not frustrate "sharply defined national or state policies prescribing particular types of conduct"*, (4) the considerations which prompted the petitioners to enter into the compromise of the suit, and (5) since the State of Texas itself, by reason of the stipulation of the parties was in no position to infer or maintain that a violation had occurred, The Tax Court itself could not so find. In the light of all these facts, The Tax Court found that the payments carried no brand as penal in nature and fell within the rule which would allow the payments as deductions.

To all of these facts considered by The Tax Court, the Circuit Court replied by determining that although recognition was accorded thereto, the penalties were nevertheless

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* Commissioner v. Heininger, supra.

penal in nature because they had been made to extinguish a cause of action to impose a penalty. It is obvious that the conclusion by the Circuit Court is based upon a fundamental *difference of fact* from the conclusion by the Tax Court. Furthermore, if the Circuit Court reasoning is sound for the conclusion reached, it would do violence to the established rule for deductions following successful defenses of causes of action which charged defendants with violations of law. It would be just as logical (following the Circuit Court's reasoning) to say that amounts expended in the *successful defense* of alleged violations of law were in reality amounts paid to extinguish a cause of action to impose a penalty. This determination would fix their character as non-deductible expenditures.

The cases cited by the Circuit Court in its opinion to support the principle regarded as requiring a reversal of The Tax Court decision do not support in fact the principle announced by the Circuit Court in its instant opinion.

In UNITED STATES v. JAFFRAY (C.C.A. 8, 1938), 97 F. (2d) 488, the amount of a penalty was compromised, there being no question of the *fact* of the *existence* of the penalty. In the JAFFRAY case, supra, the payment was not made to extinguish a cause of action to impose a penalty, but rather was made in satisfaction of a recognized, existing penalty.

In STANDARD OIL COMPANY v. COMMISSIONER, supra, a consent decree, with its surrounding circumstances, established the guilt of the parties involved. The Board of Tax Appeals (now The Tax Court), found as a fact that the transaction which resulted in said payment, was *mala fides* and fraudulent, and thereby established beyond doubt the *nature* of the payment.

In HELVERING v. SUPERIOR WINES & LIQUORS, INC., supra, the taxpayer successfully abated the amount of an alleged violation by contending that such violations were due to

"ignorance of regulation and procedure," for which reasons an offer in compromise was made. (Compare with reasons for compromise here.) However, the fact that the taxpayer there had committed the violation was not open to doubt and the rule in the JAFFRAY case, supra, was held to apply. (The status or authority of SUPERIOR WINES, supra, is in doubt since HEININGER v. COMMISSIONER, supra.)

Opposed to the established fact of a violation in each of the three cases commented upon above, the instant proceedings show no such fact, but rather, by the stipulation of the parties that the payments shall in no way be construed as an admission of guilt or against interest, there is established the absence of such factor, which compelled The Tax Court to its conclusion. It is this essential fact which the Circuit Court has overlooked in an attempt to apply a principle of law and thereby avoid the obligation with respect to the finality of The Tax Court's findings on questions of fact.

Finally, although every case of this type must, in a sense, stand on its own facts, if the two tests outlined in the HEININGER case, supra, are applied, the Circuit Court has departed from the accepted and usual course of judicial proceeding on review, and the exercise of this Court's power of supervision is in order. Test one of the HEININGER case, supra, is the relation of the expenditure to the taxpayer's business. The finding by The Tax Court that the expenditure was directly connected to the operations of the petitioner's business was not disturbed by the Circuit Court. Test two is whether the payment frustrates "sharply defined national or state policies proscribing particular types of conduct." As a guide to the application of this test, this Court said in the HEININGER case:

> "It has never been thought, however, that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible."

With respect to test two, The Tax Court found as a fact, and with evidence to support such finding, that the payment by the petitioners did not frustrate sharly defined policies of the State of Texas proscribing combinations or agreements in restraint of trade. The Circuit Court held that public policy must have been frustrated because in its opinion the payments were penal in character. Thus, throughout its opinion, the Circuit Court is unable to lift the payments out of the penal category and reach the fact as found by The Tax Court that the facts showed the payments to be not penal or in lieu of penalties. Therefore, the rule of law announced by the Circuit Court was applied to a set of facts at variance with the facts found by The Tax Court.

2.

The Circuit Court of Appeals has decided a question of importance to the administration of Federal law which has not been, but should be settled by this Court.

The question of whether amounts paid in compromise of an asserted claim for penalty for a violation of a State or Federal statute where the violation is neither admitted nor established, and where the motivation for the settlement of the claim is for reasons other than certainty of guilt or fear of conviction, are permissible deductions has not been decided in any case other than that sought to be reviewed herein. It is an important question of Federal law because of the number of wartime measures which are implemented by sanctions that amounts paid or collected in contravention of statutory regulations shall not be allowed as an ordinary and necessary business expense for Federal income tax purposes. See Section 4001.10 of the regulations of the Economic

Stabilization Director issued October 27, 1942, and Section 904.5 of Regulation No. 4 of the Chairman of the War Manpower Commission effective April 18, 1943, as amended October 20, 1944, 9 FEDERAL REGISTER No. 210, page No. 12672; and because of emergency statutes which provide for civil penalties for violations of regulations issued thereunder, which are subject to honest dispute in interpretation, such as the Emergency Price Control Act, 56 Stat. 23. It is probable that many taxpayers have made compromises of claims asserted for alleged violation of these and similar statutes and statutory regulations under circumstances similar to the compromise payment made by the taxpayer in this case. It is probable also that other taxpayers are now contemplating the making of such compromises, dictated by such considerations. The importance of this question of Federal law, presently undecided by this Court, to such taxpayers is obvious.

The Circuit Court of Appeals has erroneously decided this important question of Federal law. It has decided it on the erroneous proposition that any compromise payment which extinguishes a cause of action to impose a penalty is a payment as a penalty. See earlier comments on cases of JAFFRAY, STANDARD OIL COMPANY and SUPERIOR WINES & LIQUORS, INC., supra.

The Tax Court's reasoning reaches the proper result in this case. "Financially the petitioners were convinced that it would cost more to litigate the suit even though they received a favorable verdict. Economically the injunction would not prevent them from carrying on their business so long as they did not act under an agreement with competitors as to the conduct thereof. Actually the disruption of their business because of the absence of their officers and key men in their organizations plus the unfavorable publicity attendant upon the trial might be more damaging to each of the petitioners than the amounts of the compromise pay-

ments. Since taxation is a practical matter, the practical aspects of a tax problem should be faced and considered in determining tax liability. * * * Our view is that under all the facts and circumstances, the attorney's fees, the related expenses, and the compromise payments were ordinary and necessary expenses paid in carrying on petitioner's respective business and we so hold."

3.

The decision by the Circuit Court of Appeals is in conflict with the weight of applicable authority pertaining to the regard to be accorded compromise settlements.

The last reason stated for granting the writ digs deeply into what are deemed fundamental concepts of law which the Circuit Court, in viewing these procedures in the narrow field of taxation, has lost sight of.

It is essential to this phase of the argument to keep in mind that under the facts here present, no violation of law or guilt on the part of the petitioners has been established or can be inferred. In the absence of such fact or the right to draw inferences, can a conclusion be made, as did the Circuit Court, that because a compromise was reached, the effect is the same as though such fact or inference did exist?

It has long been established as a sound principle of public policy that settlements of disputed claims are to be favored and no inference or conclusion should be drawn therefrom. 20 Am. Juris. 477, 11 Am. Juris. 249. In 15 C. J. S. 737, it is stated:

> "The compromise and settlement of a claim or cause of action is not an admission that the claim is valid, but

> merely admits that it is a dispute, and that an amount is paid to be rid of the controversy; * * * "

See also 31 C. J. S. 1040; WIGMORE ON EVIDENCE, Vol. 4 (3rd Ed.), page 28.

Contrasted with the above rule, the Circuit Court, in its opinion, stated that as applied in the field of taxation such a compromise payment could only be regarded as a penalty payment and on that basis an unallowable deduction. Instead of drawing the inference that the payments were in lieu of penalties, it might be just as logical to draw the opposite inference. The Tax Court found, with facts to support such finding, that the payments were made for business considerations heretofore recited and therefore allowable deductions. In the case of WEST v. SMITH (1879), 101 U.S. 263, 273, this Court stated:

> "By all or nearly all the cases, the rule as established is not that an admission made during or in consequence of an effort to compromise is inadmissible, but that an offer to do something by way of compromise, as to pay sums of money, allow certain prices, deliver certain property, or make certain deductions, and the like, shall be excluded. These cannot be called admissions, as they were made to avoid controversies and to save the expenses of vexatious litigation."

The Circuit Court was obviously swayed in its decision by the recital in the stipulated judgment by the local state court to the effect that the amounts paid were "in full satisfaction of all claims of the State of Texas for penalties for the alleged violations of law." But the Circuit Court failed to give credence to the fact that The Tax Court itself recognized this statement and found ample evidence which overcame the import of that recitation. This Court said in the case of WEST v. SMITH, supra (page 270):

"* * * where the effect of a written instrument collaterally introduced in evidence depends not merely upon its construction and meaning, but also upon extrinsic facts and circumstances, the inferences to be drawn from it are inferences of fact and not of law, and of course are open to explanation."

If the Circuit Court opinion is allowed to destroy the long established principle which favors settlements of litigation, taxpayers, no matter how vexatious or how many business reasons may dictate otherwise, will be forced to litigate a charge against them which might be interpreted to be of such a nature as to constitute a penalty payment because that will be the only way left open to an expenditure which can be regarded as an ordinary and necessary business expense within the purview of Section 23 (a) (1) (A) of the INTERNAL REVENUE CODE. This is not the result which the law seeks to accomplish by favoring or encouraging settlements.

It is respectfully submitted that this petition should be granted.

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CITATIONS

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In the Supreme Court of the United States

October Term, 1945

No. 156

Longhorn Portland Cement Company,
petitioner

v.

Commissioner of Internal Revenue

San Antonio Portland Cement Company,
petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 38–50) are reported at 3 T. C. 310. The opinion of the Circuit Court of Appeals (R. 104–106) is reported at 148 F. 2d 276.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 27, 1945. (R. 106–107.) The petition for a writ of certiorari was filed June 22, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the $50,000 each taxpayer paid in 1939 in compromise of an antitrust suit brought against them by the State of Texas constituted ordinary and necessary expenses incurred in carrying on trade or business, deductible from gross income under Section 23 (a) (1) (A) of the Internal Revenue Code, as amended.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. [As amended by Section 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798.]
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.
>
> (26 U. S. C. Sec. 23.)

STATEMENT

The Commissioner determined deficiencies in 1939 income tax and excess profits tax against taxpayer Longhorn Portland Cement Company and in 1939 income tax against taxpayer San Antonio Portland Cement Company. (R. 38.) The deficiencies resulted principally from the disallowance as deductions from gross income of (1) the $50,000 paid by each taxpayer in compromise of an antitrust suit brought against both taxpayers by the State of Texas and (2) attorneys' fees and legal expenses paid by each taxpayer as an incident to that proceeding. (R. 17, 34.) Taxpayers each filed a petition for review by the Tax Court contesting the disallowance of these deductions (R. 6-13, 22-30) and the two cases were consolidated (R. 38). The Tax Court held that the deductions were properly taken under Section 23 (a) (1) (A) of the Internal Revenue Code, as amended, as ordinary and necessary business expenses. (R. 45-50.) The Commissioner appealed from this holding in so far as it related to the payments in compromise of the antitrust proceeding. (R. 53-58, 63-67.) On appeal, the Circuit Court of Appeals reversed the Tax Court, holding that the compromise sums are not deductible because they were paid to the State of Texas as statutory penalties. (R. 104-106.)

The pertinent facts, as found by the Tax Court (R. 39–45), may be summarized as follows:

Taxpayers are corporations organized under the laws of Texas. Prior, subsequent to, and during the taxable year they were engaged in the manufacture and sale of cement, each having gross sales for 1939 of approximately $2,000,000. Their income and excess profits tax returns for the taxable year were filed with the Collector of Internal Revenue for the First District of Texas at Austin. (R. 39.)

On March 7, 1938, the State of Texas filed a suit, captioned *State of Texas* v. *Lone Star Cement Corporation, et al.*, in which the six cement companies then operating in Texas including the two taxpayers, were made defendants. The State's petition alleged violations of the antitrust laws of Texas and sought recovery of penalties, forfeiture of charters or rights to do business in Texas, as the case might be, establishment and foreclosure of alleged liens, and injunctive relief against alleged conspiracies and agreements. (R. 43.) On November 12, 1938, the State filed an amended petition, continuing the suit against the four major companies but omitting taxpayers therefrom. After the filing of the amended petition, evidence was taken. The record was voluminous, consisting of over 6,000 pages of stenographic record and over 3,000 pages of exhibits. (R. 43.)

Prior to October 4, 1939, an agreement to compromise this suit was negotiated between the four remaining defendants and the attorney general, but the defendants insisted that they should not be bound by injunctions unless their competitors were also bound, on account of the adverse effect upon their business unless this was done. A suit, entitled *State of Texas* v. *San Antonio Portland Cement Company, et al.*, was thereupon filed by the State against taxpayers, but they refused to agree to any compromise. On October 4, 1939, an interlocutory decree was entered in the previous suit, which provided for injunctive relief against the four defendants and for the payment of $400,000 by them to the State; but the interlocutory decree also provided that no final decree should be entered awarding injunctive relief unless similar relief in part was obtained by the State against taxpayers and the Gulf Portland Cement Company. (R. 39, 43.)

The Gulf Portland Cement Company was subsequently made a party defendant in the suit which had been instituted against the taxpayers. (R. 44.) In its petition in this suit the State alleged that the defendants had violated the anti-trust laws of the State of Texas in various respects set out in great detail and sought to recover statutory penalties of from $50 to $1,500 per day from January 1, 1930, to the date of filing suit, a judgment canceling and forfeiting taxpayers'

charters, a judgment establishing and foreclosing a statutory lien for the penalties upon the defendants' property, and a judgment enjoining and restraining each defendant from carrying out alleged agreements, conspiracies, trusts, and combinations and for other general and special relief. The answers of each taxpayer to this suit consisted of a general demurrer, a general denial, and a special denial that any acts, methods, or practices used in its business were a result of, or pursuant to, any agreement or for any unlawful purpose. No evidence was ever taken. (R. 39–40.)

Taxpayers' officers and directors were advised by their respective counsel that they had a good defense to the suit, but they were induced to and did compromise the suit in 1939, with the result that each paid the State of Texas $50,000. (R. 39, 40.) The compromise was entered into by taxpayers because of the following considerations (R. 40):

> (a) From the advice and information given them by their attorneys they became convinced that it would cost less to so settle than the expense of carrying the litigation to its end, even though successful.
>
> (b) Disruption of their respective businesses would result from the attendance of officers at hearings for the taking of evidence and a long trial of the case.
>
> (c) Unfavorable publicity would result from the newspaper reports of the trial,

which would have a damaging effect upon their businesses.

(d) The injunctive relief sought by the state would not prevent them from carrying on business according to the prices charged and practices pursued so long as they did not act pursuant to any agreement with one another, or with any other competitor, and they contended that they had not made or joined in any agreement as to the conduct of their businesses.

Judgment as a result of the compromise was rendered on December 15, 1939, and specifically recited in detail the agreement of the parties.[1] (R. 40.) The compromise agreement stated, among other things, that the defendants severally denied that their practices were the result of any agreement, express or implied, or were followed for any unlawful purpose, and also provided that (R. 42):

> This agreement is made by the parties hereto solely and only for the purpose of compr[om]ising and settling the matters

[1] Original Exhibit E, which taxpayers have not had forwarded to this Court, shows that the compromise agreement, after providing for payment of the compromise sums, set out at length the different things which the defendants were to be enjoined from doing. These included a provision against following, except by independent action, any code, compendium or agreement theretofore or thereafter adopted or promulgated by the Cement Institute and an injunction against taxpayers' execution of the statements they had made to their Texas trade concerning their selling policy.

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> involved in this suit, by and between the State of Texas, as plaintiff, and the defendants herein named, and it is expressly understood and agreed as a condition hereof, that neither this agreement nor the judgment to be entered thereon, nor any clause or provision of said agreement or judgment, shall constitute or be construed to be an admission or estoppel as against the various defendants herein as evidencing or indicating in any degree an admission of truth or correctness of the allegations in plaintiff's petitions contained in whole or in part.

After reciting the provisions of the agreement, the judgment provided (R. 41):

> And it appearing to the Court that said agreement is proper and in keeping with the law in such cases made and provided, and that same should be approved, and that final judgment be entered in keeping therewith, it is:
>
> FIRST
>
> THEREFORE ORDERED, ADJUDGED AND DECREED that the agreement heretofore entered into between the parties to this cause be and the same is hereby in all things approved.
>
> SECOND
>
> IT IS FURTHER ORDERED, ADJUDGED AND DECREED that plaintiff, the State of Texas, have and recover of and from the defendants, San Antonio Portland Cement Company

and Longhorn Portland Cement Company, jointly and severally, the sum of One Hundred Thousand ($100,000.00) Dollars in full satisfaction of all claims of the State of Texas for penalties for the alleged violations of law set out in Plaintiff's Original Petition, and in full satisfaction of all expenses of the Attorney General in investigating, instituting and preparing this cause for trial; and all costs of suit are hereby adjudged against the defendants, San Antonio Portland Cement Company and Longhorn Portland Cement Company, jointly and severally, but plaintiff shall not recover of and from the Gulf Portland Cement Company any sum of money whatsoever, nor shall any costs of suit be adjudged against defendant Gulf Portland Cement Company.

THIRD

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the Clerk of this Court shall issue to each of the defendants in this cause, including the Gulf Portland Cement Company, a writ of injunction in full conformity with the provisions of said agreement, and that no bond shall be required of plaintiff.

Pursuant to this judgment, the District Court of Travis County issued a permanent injunction against taxpayers and the Gulf Portland Cement Company in conformity with the compromise agreement. (R. 41–42.)

On the basis of these facts, the Tax Court found as a fact that the amounts taxpayers paid in compromise of the suit brought against them by the State of Texas were ordinary and necessary expenses paid or incurred in the carrying on of a trade or business. (R. 44–45.)

ARGUMENT

The decision of the court below was based upon the proposition of law that sums paid pursuant to a compromise judgment in a suit for statutory penalties, in satisfaction of the State's claim, are paid as penalties and are not deductible as "ordinary and necessary business expenses" under Section 23 (a) (1) (A) of the Internal Revenue Code. The validity of this proposition would present an important question of Federal law if the answer were in doubt; but we submit that the decision below was clearly right and in accord with previous decisions and that no occasion is presented for the issuance of a writ of certiorari. There is no conflict of decisions among circuit courts of appeals. Moreover, the taxpayers concede that if sums paid pursuant to a compromise judgment are in fact paid as penalties, they are not deductible. It is argued merely that in this case the Tax Court found they were not so paid and that the failure of the Circuit Court of Appeals to give effect to this finding was a disregard of the principle of *Dobson* v. *Commissioner,* 320

U. S. 489. We think, however, that the doctrine of the *Dobson* case was correctly applied.

The rule is undoubted (R. 48; Pet. Br. 13) that where a taxpayer has incurred a fine or penalty for violation of a Federal or a state statute he is not permitted a tax deduction for its payment. *Commissioner* v. *Heininger,* 320 U. S. 467, 473; *Helvering* v. *Superior Wines & Liquors,* 134 F. 2d 373 (C. C. A. 8th); *United States* v. *Jaffray,* 97 F. 2d 488 (C. C. A. 8th), affirmed on other grounds, *sub nom. United States* v. *Bertelsen & Petersen Co.,* 306 U. S. 276; *Standard Oil Co.* v. *Commissioner,* 129 F. 2d 363 (C. C. A. 7th), certiorari denied, 317 U. S. 688; *Chicago, R. I. & P. Ry. Co.* v. *Commissioner,* 47 F. 2d 990 (C. C. A. 7th), certiorari denied, 284 U. S. 618; *Tunnel R. R.* v. *Commissioner,* 61 F. 2d 166 (C. C. A. 8th), certiorari denied, 288 U. S. 604; *Great Northern Ry. Co.* v. *Commissioner,* 40 F. 2d 372 (C. C. A. 8th), certiorari denied, 282 U. S. 855; *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. 2d 178 (C. C. A. 2d); see also Note, 54 Harv. L. Rev. 852 (1941); 4 Mertens, Law of Federal Income Taxation, Sec. 25.35–25.37, 25.102–25.105. The reason for the rule is that to allow the deduction would confer a tax advantage which mitigated the penalty and to that extent to frustrate the purpose of the legislation imposing it. *Commissioner* v. *Heininger, loc. cit. supra; Burroughs Building Material Co.* v. *Commissioner,*

supra; Great Northern Ry. Co. v. *Commissioner, supra.* Clearly this reason extends to payments resulting from the compromise of penalty suits, at least where judgment is entered; for a compromise settlement followed by judgment, not less than a judgment imposing a penalty after a trial upon the merits, represents a sanction authorized by law in order to effectuate the statutory purpose. *United States* v. *Chouteau,* 102 U. S. 603, 611. A civil action to recover penalties is, of course, in the same category as a criminal prosecution for many purposes, *United States* v. *La Franca,* 282 U. S. 568; *United States* v. *Chouteau, supra,* and this has been held specifically with reference to the Texas antitrust act. See *Waters-Pierce Oil Co.* v. *State of Texas,* 48 Tex. Civ. App. 162, writ of error refused, 103 Tex. 676, affirmed, 212 U. S. 86, in which the Court of Civil Appeals stated that "the penalties prescribed were intended as punishment" (48 Tex. Civ. App. at p. 181).

Although it is true in this case, as the Tax Court stated (R. 50), that "the state is in no position under the judgment entered to say that petitioners were convicted of any violations of its antitrust statutes", it is equally true that the State of Texas deemed the evidence of illegal conduct on the part of the taxpayers to be sufficiently weighty to justify the institution of suit; that the taxpayers' competitors were unwilling to con-

tinue their businesses subject to an injunction unless the taxpayers were also enjoined from illegal conduct (see *supra*, p. 5); and that the taxpayers agreed to joint and several liability to pay $100,000 to settle the suit. These factors do not yield to the taxpayers' stipulation in the compromise agreement against admission of guilt of the illegal practices charged; for that provision of the agreement has no bearing upon the "sharply defined" policies (*Commissioner* v. *Heininger*, *loc. cit. supra*) lying behind the State's suit and the resulting judgment. Indeed, as the Tax Court found (R. 48–49), the judgment in the anti-trust suit against the taxpayers specified that the State of Texas have and recover $100,000 from them "in full satisfaction of all claims of the State * * * for penalties for the alleged violations of law set out in Plaintiff's Original Petition * * *."[2] The purpose of this judgment requires the protection against impairment by operation of the tax laws which this Court recognized as necessary in the *Heininger* case.

The decisions in *Helvering* v. *Superior Wines and Liquors*, 134 F. 2d 373 (C. C. A. 8th) and

[2] The judgment also stated that the $100,000 was "in full satisfaction of all expenses of the Attorney General in investigating, instituting and preparing this cause for trial." (R. 49.) Tex. Rev. Stat. (Vernon, 1939), Art. 7436, provides for payment of a percentage of the penalties collected in an antitrust action to the district or county attorney as fees for representing the State under the direction of the Attorney General.

United States v. *Jaffray,* 97 F. 2d 488 (C. C. A. 8th), affirmed on other grounds *sub nom. United States* v. *Bertelsen and Petersen Co.,* 306 U. S. 276, involving compromise payments in settlement of penalties, support this view and were followed in the court below (R. 106). They may not be distinguished from the instant case on the ground asserted by taxpayers (Br. 15–16), that they involved the "established fact of a violation" (Br. 16), whereas in the present case the compromise judgment negatived any admission of guilt; for the considerations to which we have adverted are of over-riding significance. *Standard Oil Co.* v. *Commissioner,* 129 F. 2d 363 (C. C. A. 7th), certiorari denied, 317 U. S. 688, involved the deductibility of a payment in settlement of an action for conversion of the Government's property. It was necessary to establish that the conversion had been with guilty knowledge, since payments in satisfaction of tort liability are otherwise deductible. Guilty knowledge having been found by the Board of Tax Appeals, the payment was deemed to result from a tort which was "also violative of the criminal statutes" and which, like conviction of an offense, could "not furnish the basis of deduction" (129 F. 2d at p. 371).

As against these considerations, the view of the Tax Court (R. 49–50) that the tax significance of payment of a compromise judgment for penalties may be determined as a question of fact in each case, turning upon "practical aspects that con-

fronted" the taxpayer, is, we submit, inadmissible. The Tax Court recognized (R. 49) that "if unexplained" the judgment of the Texas court "would weigh heavily against" the taxpayers. As the Circuit Court of Appeals correctly held (R. 106), that judgment speaks for itself and may not be explained away; the claimed deduction "was paid as a penalty" pursuant to it, regardless of taxpayers' intention or of collateral circumstances. Tax consequences are determined by the nature of transactions upon which they turn and not ordinarily upon the motives or ideas of taxpayers with regard to their acts. Cf. *Whitehead* v. *Commissioner,* 148 F. 2d 718, 720 (C. C. A. 4th). This is especially true when the transaction is with a sovereign. The decision of the Tax Court was properly reversed for error of law. See *Trust of Bingham* v. *Commissioner,* No. 932, October Term, 1944, decided by this Court June 4, 1945. We think, therefore, it would have been of no consequence if the Tax Court had, as petitioner asserts, made a "finding" that the amount was not a penalty. It may be noted that the court made no such finding but, rather, held that the absence of an admission of guilt meant that the tax consequences of allowing the deduction would not frustrate the public policies of the State of Texas. (R. 50.) This, however, was not a determination to which the principle of the *Dobson* case accords finality.

The policy which taxpayers cite (Br. 19–21), favoring compromise settlement of litigation, does

not go to the length of requiring that tax inducements be offered to encourage voluntary partial payment of statutory penalties with part of the resulting burden transferred to the Federal Government. Hence it offers no argument against the correctness of the decision below. In other situations the policy of encouraging compromise settlement of lawsuits has not been regarded as affording a justification for conferring a tax advantage because a suit or claim was settled for less than the amount sought. See *United States* v. *Safety Car Heating Co.,* 297 U. S. 88, 99–100; *Hort* v. *Commissioner,* 313 U. S. 28; cf. *Lyeth* v. *Hoey,* 305 U. S. 188. Here the allowance of the tax benefit would fly in face of the reason for the nondeductibility of penalty payments, discussed above. And this would be true with respect to penalties for violation of the wartime measures mentioned by taxpayers (Br. 17–18),[3] equally with penalties under earlier laws.

[3] Section 4001.10 of the Regulations of the Economic Stabilization Director, issued October 27, 1942 (7 Fed. Reg. 8748), as amended November 30, 1942 (7 Fed. Reg. 10024), implementing the Emergency Price Control Act, c. 26, 56 Stat. 23, and made applicable also to Regulations No. 4 of the War Manpower Commission (Section 904.6 of Regulations No. 4 of the Chairman of the War Manpower Commission, effective April 18, 1943, 8 Fed. Reg. 5137), provides that wage and salary payments made in violation of the regulations may not be deducted as business expenses for income tax purposes. No problem of the deductibility of sums paid in the compromise settlement of claims seems likely to arise under this provision, which deals wholly with the tax consequence of certain payments actually made in the course of

CONCLUSION

The decision below is correct and involves no conflict of decisions or important, unsettled question of law. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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JULY 1945.

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business, in the absence of any penal proceeding. Nondeductibility is itself one of the prescribed consequences. Insofar as penalty payments or payments in compromise of penalty actions may be made under this and other statutes and regulations, the principle of nondeductibility clearly applies.

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